FOMC: Delivers on expected lines; for markets it was not as hawkish as feared

- **At the conclusion of its policy meeting, the FOMC met expectations by raising the policy rate by 50bps and launching QT. The initial phase of QT over June-August was lower than expectations but should increase from September onwards**
- **The post policy statement and the FOMC Chair emphasized that focus for the central bank will be on tackling the ongoing inflation risk. The FOMC Chair emphasized that the committee is still working with a 'soft-landing' scenario**
- **However, the FOMC Chair ruled out the possibility of a one-off 75bps rate hike with the future rate trajectory expected to be contingent on the manner in which inflation pans out**
- **We see 50bps rate hikes over June and July policy meetings respectively with the fed funds rate likely to reach the 2.75% mark by December 2022 and to the 3.5% mark by December 2023. QT is likely to remain in operation over 2022 and 2023**
- **Risk sentiment got a leg-up as the policy outcome was not viewed to be as hawkish as some participants feared**
- **We see the downward drift in US yields and USD to remain temporary. A gradual tightening in US monetary policy will work as the main driving force for the market over 2022**

FOMC tightens policy further: The FOMC raised the fed funds rate by 50bps to 0.75% to 1.00% range and launched QT on expected lines. The initial pace of QT will be to the tune of USD 47.5bn over June-August that will be increased to USD 95bn from September onwards. Hence, the Fed will reduce its balance sheet by USD 522bn in 2022 and possibly by USD 1.1tn over 2023. The interest paid on reserve balances was also revised higher to 0.9% and the overnight repurchase agreement minimum bid rate was kept at 1%. **In justifying its decision, the FOMC post policy statement indicated that the focus remains on fighting inflation by reiterating that the 'committee is highly attentive to inflation risk'. The post policy statement also acknowledged the impact that the Russia-Ukraine conflict and China lockdowns will have on raising inflation, although growth could weaken on the margin as well in response to these two new developments.** Nevertheless, the underlying focus was on bringing inflation lower that was emphasized in the Fed Chair's press conference too.

Guidance: Not as hawkish as feared but commitment to tightening was made: For the market, the focus was on the guidance on the road ahead with regards to the pace of tightening. **In this regard, the FOMC Chair played down the possibility of a 75bps rate hike by stating that it is 'not being actively considered by the committee'. However, he did emphasize that 50bps rate hike over the next two meetings is still on the table similar to what is currently priced in by the market.**

Nevertheless, the FOMC Chairman did emphasize that the focus for the committee is to tighten policy to bring inflation under control given that labour markets remain fairly tight. Although wages were acknowledged to being elevated partly because of reduced labour supply, the FOMC Chair downplayed risk of a wage-price spiral at the current juncture. Demand and supply for labour were expected to balance out further over 2022 that might slowly restrain a further sharp rise in wage price inflation. Powell stated that once there is evidence of inflation moderating on a structural basis, the FOMC could move to hiking rates by 25bps increments that could come later in 2022.

The FOMC Chair also emphasized that if required in case inflation remains elevated, the committee will not have a problem in taking the policy rate to restrictive territory above the estimated neutral level of 2.4% to 2.5% mark. Some softening in sequential momentum in core inflation in the last print in March was viewed as encouraging but not adequate to force a change. **In short, the tightening path will remain contingent on the manner in which inflation trend pans out.**

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FOMC maintains its soft-landing scenario: The post policy statement downplayed the contraction in GDP in Q12022 by stating that private demand remains strong that was on expected lines. This message was echoed by the FOMC Chair who emphasized that 'growth will remain solid in 2022'. Private sector balance sheets were deemed to be strong enough to withstand a sharp pace of tightening in monetary policy. Labour markets were expected to remain strong with the unemployment rate expected to remain below the full-employment level. Labour supply was expected to improve that would limit a sharp downward drift in the unemployment rate. **Hence, focus for the FOMC has to be on ensuring that the risk of a wage-price inflation spiral remains limited. Inflation was acknowledged as a concern but should moderate once the effects of tighter monetary policy and financial conditions start to weaken demand to a degree.** However, the FOMC Chair emphasized that the central bank cannot influence supply-side drivers of inflation that might increase given the lockdowns in China and the commodity price shock from the Russia-Ukraine conflict.

Nevertheless, the FOMC Chair emphasized that the committee does not see the risk of a hard-landing as yet and is instead pencilling in a 'soft-landing' scenario. He downplayed a comparison with what happened during the period of 1980s of the Volcker shock when aggressive tightening from the US central bank pushed the economy in to a recession.

Outlook: More tightening on the cards: We maintain that the FOMC will continue with its tightening path with a 50bps rate hike likely in June followed by another 50bps rate hike in July. The outlook beyond July will remain contingent on the manner in which inflation pans out and on whether there is a risk of another inflation shock.

We think that the case for either a 25bps or 50bps rate hike in the September policy meeting will remain a close call. In case, inflation shows signs of moderating on a sequential basis, we see the FOMC hiking rates by 25bps increments in the policy meetings in September, November and December respectively. However, if inflation remains much more elevated than we currently assume, much more aggressive rate hike trajectory is quite possible with a possible 50bps rate hike in September. We think that the fed funds rate will end December 2022 at least the 2.5% to 2.75% range with risk that it could be much higher if inflation surprises to the upside. We see case for another 50-75bps rate hike over 2023 as inflation remains elevated but grinds lower at a slower pace. QT should remain on auto-pilot mode based on the guidance provided. **Hence, we see the terminal fed funds rate at 3.5% much above the 2.5% rate that was seen in the last hiking cycle over 2016-18 primarily reflecting a much higher inflation trajectory that requires a relatively tighter monetary policy regime.** We see US PCE inflation moderating to the 4.5% mark by December 2022 and to the 2.3% mark by December 2023 assuming that there are no further commodity price shocks.

The fed funds futures market is fully pricing in a 50bps rate hike each in June and July respectively. This is followed by 40bps hike in September, 28bps hike in November and 22bps hike in December respectively.

Markets: Temporary relief: For markets, the defining driver was the FOMC Chair ruling out a possible 75bps rate hike and providing a rate hiking guidance in sync with what has already been priced in. Besides, the initial pace of QT over June-August was also much slower than previously expected. The net result has been a sharp rise in equity markets, fall in US yields that was more pronounced at the shorter segments and downward move in the DXY. However, we do not expect these trends to sustain as the FOMC moves forward with its plans to both hike rates and continue with QT. The net result will be a continued tightening in financial conditions. **Investors also appear to have ignored the sharp intra-day rise that has taken place in global crude oil prices in response to EUs decision to phase-out Russian energy imports over a six month period. Hence, we do not think that the improvement in risk sentiment will sustain on a structural basis.**

We see US yields trading flat in the near-term but maintain our call of an upward drift in the medium-term as the FOMC pushes forward with its tightening plans. There could be a mild steepening bias in the near-term given that shorter end yields such as the 2-year yield fell by 20bps and longer-end 10 year yield fell by only 9bps in response to the FOMC outcome. The launch of QT could also asymmetrically support longer-end yields. We see the UST 10 year yield trading in the 2.8% to 3.1% range in the near-term and the UST 2 year yield trading in the 2.6% to 2.9% range in the near-term. However, we maintain our December-2022 target for the UST 10 year to drift to the 3.25%-3.50% range while the UST 2 year should drift to the 3%-3.25% range. We think that the yield curve will invert in H12023 as concern about US growth prospects take center stage and as the FOMC could be in the last leg of its rate hiking cycle that will in turn start pushing longer-end yields lower.

We see possible range trading in the near-term in the DXY while USD/EM might also trade lower. However, as the FOMC drains USD liquidity from the financial system, we see case for further uptrend over June-September for the DXY. Monetary divergence will remain the dominant theme with the FOMC expected to tighten policy at a much faster pace than the other G-10 central banks. Hence, the DXY is expected to trade in the 101-103 range with an upside of 104. We see the DXY topping out in Q42022. Post an interim relief rally in the near-term, USD/EM should trade with an upside bias over 2022 responding to rising DM yields and a sharp tightening in global monetary policy.

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